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Modern Corporate Finance, Investments and Taxation

 Springer

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Preface

This book describes in detail the modern theory of corporate finance, investment, and taxation, created by Brusov, Filatova, and Orekhova (BFO theory), which has replaced the famous theory of capital cost and capital structure by Nobel laureates Modigliani and Miller. The authors have moved from the assumption of Modigliani-Miller concerning the perpetuity (infinite time of life) of companies and further elaborated quantitative theory of valuation of key parameters of financial activities of companies with arbitrary time of life (of arbitrary age).

Results of modern BFO theory turn out to be quite different from those of Modigliani-Miller theory. They show that the latter, via its perpetuity, underestimates the assessment of weighted average cost of capital, WACC, and the equity cost of the company and substantially overestimates the assessment of the capitalization of the company.

Such an incorrect assessment of key performance indicators of financial activities of companies has led to an underestimation of risks involved, and impossibility, or serious difficulties in adequate managerial decision-making, which was one of the implicit reasons of global financial crisis in 2008.

Within new modern theory of capital cost and capital structure (BFO theory), a lot of qualitatively new results have been obtained, among them:

1. The qualitatively new effect in corporate finance, discovered by authors: abnormal dependence of equity cost on leverage, which alters the main principles of the company's dividend policy significantly.
2. Bankruptcy of the famous trade-off theory has been proven.
3. A very important discovery has been done recently: the valuation of WACC in the Modigliani-Miller theory (perpetuity limit) is not minimal and valuation of the company capitalization is not maximal, as all financiers supposed up to now: at some age of the company ("golden age") its WACC value turns out to be lower than in perpetuity limit and company capitalization V turns out to be greater than perpetuity limit of V .

4. Mechanism of formation of the company optimal capital structure, different from the one suggested by trade-off theory, has been suggested.
5. The inflation in both Modigliani-Miller as well as in Brusov-Filatova-Orekhova theories has been taken into account in explicit form, which has a nontrivial impact on the dependence of equity cost on leverage.
6. Study of the role of taxes and leverage has been done, which allows the Regulator to set up the tax on profits rate and allows businessmen to choose the optimal level of debt financing.
7. Investigation of the influence of tax on profit rate on the effectiveness of investment projects at different debt levels has showed that increase of tax on profit rate from one side leads to decrease of project NPV, but from other side it leads to decrease of sensitivity of NPV with respect to leverage level. At high leverage level L , the influence of tax on profit rate change on effectiveness of investment projects becomes significantly less.
8. Studying the influence of growth of tax on profit rate on the efficiency of the investment as well has led to two qualitatively new effects in investments:
 - the growth of tax on profit rate changes the nature of the NPV dependence on leverage L : at some value t^* , there is a transition from diminishing function $NPV(L)$ at $t < t^*$ growing function $NPV(L)$ at $t > t^*$.
 - at high leverage levels, the growth of tax on profit rate leads to the growth of the efficiency of the investments.

Discovered effects in investments can be applied in a real economic practice for optimizing of the management of investments.

Established BFO theory allows us conduct a valid assessment of the core parameters of financial activities of companies, such as weighted average cost of capital, equity capital cost of the company, and company's capitalization. It allows the management of a company to make adequate decisions, which improves the effectiveness of the company management. More generally, the introduction of the new system of evaluation of the core parameters of financial activities of companies into the systems of financial reporting (IFRS, GAAP, etc.) would lead to a lower risk of global financial crisis.

The second part of this book is devoted to the assessment of effectiveness of investment projects created by the authors within the modern investment models. The determination of the optimal leverage level for investments is studied in this book from two points of view: from the point of view of owners of equity capital, as well as from the point of view of owners of both equity and debt capital.

Corporate management in the modern world is the management of financial flows. The proposed Brusov-Filatova-Orekhova theory allows to correctly identify discount rates—basic parameters for discounting of financial flows to arbitrary time moment, compare financial flows with a view to adopt literate managerial decisions. The discount rate is a key link to the existing financial system, on which the modern finance can be adequately built, and this proposed book can be of substantial assistance.

This book is intended for students, postgraduate students, teachers of economic and financial institutions, students of MBA program, scientists, financial analysts, financial directors of company, managers of insurance companies and rating agencies, officials of regional and federal ministries and departments, and ministers responsible for economic and financial management.

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4 February 2014

Peter Brusov

Contents

Part I Corporate Finance

1	Introduction	3
	References	6
2	Capital Structure: Modigliani-Miller Theory.	9
2.1	The Traditional Approach	9
2.2	Modigliani-Miller Theory.	10
2.2.1	Modigliani-Miller Theory Without Taxes.	10
2.2.2	Modigliani-Miller Theory with Taxes.	12
2.2.3	Main Assumptions of Modigliani-Miller Theory.	15
2.2.4	Modifications of Modigliani-Miller theory.	16
	References	25
3	Modern Theory of Capital Cost and Capital Structure:	
	Brusov-Filatova-Orekhova Theory (BFO Theory).	27
3.1	Companies with Arbitrary Lifetime (Arbitrary Age): Brusov-Filatova-Orekhova Equation.	28
3.2	Comparison of Modigliani-Miller Results (Perpetuity Company) with Myers Results (1-Year Company) and Brusov-Filatova- Orekhova Ones (Company with Arbitrary Lifetime (Arbitrary Age)).	30
3.3	Brusov-Filatova-Orekhova Theorem	32
3.4	From Modigliani-Miller to General Theory of Capital Cost and Capital Structure.	37
3.5	BFO Theory in the Case, When the Company Ceased to Exist at the Time Moment n	39
3.5.1	Application of Formula BFO-2.	41
3.5.2	Comparison of Results Obtained from Formulas BFO and BFO-2.	42
	References	45

4	Bankruptcy of the Famous Trade-Off Theory	47
4.1	Optimal Capital Structure of the Company	47
4.2	Absence of the Optimal Capital Structure in Modified Modigliani-Miller Theory (MMM Theory)	50
4.3	Analysis of the Trade-Off Theory Within the Brusov-Filatova-Orekhova Theory	51
4.4	The Causes of Absence of the Optimum Capital Structure in Trade-Off Theory	61
	References	71
5	New Mechanism of Formation of the Company's Optimal Capital Structure, Different from Suggested by Trade-Off Theory	73
5.1	Absence of Suggested Mechanism of Formation of the Company's Optimal Capital Structure Within Modified Modigliani-Miller Theory (MMM Theory)	73
5.2	Formation of the Company's Optimal Capital Structure Within Brusov-Filatova-Orekhova (BFO) Theory	75
5.3	Simple Model of Proposed Mechanism	88
	References	91
6	The Global Causes of the Global Financial Crisis	93
	References	98
7	The Role of Taxing and Leverage in Evaluation of Capital Cost and Capitalization of the Company	99
7.1	The Role of Taxes in Modigliani-Miller Theory	100
7.2	The Role of Taxes in Brusov-Filatova-Orekhova Theory	102
7.2.1	Weighted Average Cost of Capital of the Company WACC	103
7.2.2	Equity Cost k_e of the Company	105
7.2.3	Dependence of WACC and k_e on Lifetime (Age) of Company	107
	References	113
8	A Qualitatively New Effect in Corporate Finance: Abnormal Dependence of Equity Cost of Company on Leverage	115
8.1	Equity Cost in the Modigliani-Miller Theory	116
8.2	Equity Cost Capital Within Brusov-Filatova-Orekhova Theory	118
8.2.1	Dependence of Equity Cost k_e on Tax on Profit Rate T at Different Fixed Leverage Level L	120
8.2.2	Dependence of Equity Cost k_e on Leverage Level L (the Share of Debt Capital w_d) at Different Fixed Tax on Profit Rate Γ	121
8.3	Dependence of the Critical Value of Tax on Profit Rate T^* on Parameters n , k_0 , κ_d of the Company	124

8.4	Practical Value of Effect . . . . .	.128
8.5	Equity Cost of 1-Year Company. . . . .	.129
	References. . . . .	.132
9	Inflation in Brusov-Filatova-Orekhova Theory and in Its Perpetuity Limit—Modigliani-Miller Theory. . . . .	.135
9.1	Accounting of Inflation in Modigliani-Miller Theory Without Taxes. . . . .	.136
9.2	Accounting of Inflation in Modigliani-Miller Theory with Corporate Taxes. . . . .	.140
9.3	Accounting of Inflation in Brusov-Filatova-Orekhova Theory with Corporate Taxes. . . . .	.142
9.3.1	Generalized Brusov-Filatova-Orekhova Theorem . . . . .	.142
9.4	Generalized Brusov-Filatova-Orekhova Formula Under Existence of Inflation. . . . .	.143
9.5	Irregular Inflation. . . . .	.151
9.6	Inflation Rate for a Few Periods. . . . .	.151
	References. . . . .	.153
 Part II Investments		
10	A Portfolio of Two Securities. . . . .	.157
10.1	A Portfolio of Two Securities. . . . .	.157
10.1.1	A Case of Complete Correlation. . . . .	.157
10.1.2	Case of Complete Anticorrelation. . . . .	.159
10.1.3	Independent Securities. . . . .	.160
10.1.4	Three Independent Securities. . . . .	.162
10.2	Risk-free Security. . . . .	.165
10.3	Portfolio of a Given Yield (Or Given Risk). . . . .	.167
10.3.1	Case of Complete Correlation ($p_{12} = 1$) and Complete Anticorrelation ($p_{12} = -1$). . . . .	.168
	References. . . . .	.169
11	Investment Models with Debt Repayment at the End of the Project and Their Application. . . . .	.171
11.1	Investment Models. . . . .	.171
11.2	The Effectiveness of the Investment Project from the Perspective of the Equity Holders Only. . . . .	.172
11.2.1	With the Division of Credit and Investment Flows . . . . .	.172
11.3	Without Flows Separation. . . . .	.174
11.4	Modigliani-Miller Limit (Perpetuity Projects). . . . .	.175
11.4.1	With Flows Separation. . . . .	.175
11.4.2	Without Flows Separation. . . . .	.176
11.5	The Effectiveness of the Investment Project from the Perspective of the Owners of Equity and Debt . . . . .	.177
11.5.1	With Flows Separation. . . . .	.177
11.5.2	Without Flows Separation. . . . .	.178

11.6	Modigliani-Miller Limit	179
11.6.1	With Flows Separation	179
11.6.2	Without Flows Separation	180
	References	181
12	Influence of Debt Financing on the Efficiency of Investment Projects: The Analysis of Efficiency of Investment Projects Within the Perpetuity (Modigliani-Miller) Approximation.	183
12.1	The Effectiveness of the Investment Project from the Perspective of the Equity Holders Only.	184
12.1.1	With the Division of Credit and Investment Flows	184
12.1.2	Without Flows Separation	192
12.2	The Effectiveness of the Investment Project from the Perspective of the Equity and Debt Owners.	200
12.2.1	With the Division of Credit and Investment Flows	200
12.2.2	Without Flows Separation	208
	References	216
13	The Analysis of the Exploration of Efficiency of Investment Projects of Arbitrary Duration (Within Brusov-Filatova- Orekhova Theory).	217
13.1	The Effectiveness of the Investment Project from the Perspective of the Equity Holders Only.	217
13.1.1	With the Division of Credit and Investment Flows	217
13.1.2	Without Flow Separation	225
13.2	The Effectiveness of the Investment Project from the Perspective of the Owners of Equity and Debt	234
13.2.1	With the Division of Credit and Investment Flows	234
13.2.2	Without Flow Separation	242
13.3	The Elaboration of Recommendations on the Capital Structure of Investment of Enterprises, Companies, Taking into Account All the Key Financial Parameters of Investment Project	250
13.3.1	General Conclusions and Recommendations on the Definition of Capital Structure of Investment of Enterprises.	250
	References	252
14	Investment Models with Uniform Debt Repayment and Their Application.	253
14.1	Investment Models with Uniform Debt Repayment	253
14.2	The Effectiveness of the Investment Project from the Perspective of the Equity Holders Only.	255
14.2.1	With the Division of Credit and Investment Flows	255
14.2.2	Without Flows Separation.	256

14.3	The Effectiveness of the Investment Project from the Perspective of the Owners of Equity and Debt	257
14.3.1	With Flows Separation.	257
14.3.2	Without Flows Separation.	257
14.4	Example of the Application of the Derived Formulas	258
	References.	259
15	Is It Possible to Increase Taxing and Conserve a Good Investment Climate in the Country?	261
15.1	Influence of Tax on Profit Rates on the Efficiency of the Investment Projects.	261
15.2	Investment Models.	263
15.3	Borrowings Abroad.	265
15.4	Dependence of NPV on Tax on Profit Rate at Different Leverage Levels.	267
15.5	At a Constant Value of Equity Capital ($S = \text{Const}$).	268
15.6	Without Flow Separation	270
15.6.1	At a Constant Value of the Total Invested Capital ($I = \text{Const}$).	270
15.6.2	At a Constant Value of Equity Capital ($S = \text{Const}$)....	272
	References.	274
16	Is It Possible to Increase the Investment Efficiency by Increasing Tax on Profit Rate? An Abnormal Influence of the Growth of Tax on Profit Rate on the Efficiency of the Investment	277
16.1	Dependence of NPV on Leverage Level L at Fixed Levels of Tax on Profit Rate t	277
16.1.1	The Effectiveness of the Investment Project from the Perspective of the Equity Holders Only.	277
16.1.2	The Effectiveness of the Investment Project from the Perspective of the Equity and Debt Holders.	288
16.2	Dependence of NPV on Tax on Profit Rate at Fixed Leverage Levels L	294
16.2.1	The Effectiveness of the Investment Project from the Perspective of the Equity Holders Only.	294
16.2.2	The Effectiveness of the Investment Project from the Perspective of the Equity and Debt Holders.	301
	References.	308
17	Optimizing the Investment Structure of the Telecommunication Sector Company.	309
17.1	Investment Analysis and Recommendations for Telecommunication Company "Nastcom Plus".	310
17.1.1	The Dependence of NPV on Investment Capital Structure.	311
17.1.2	The Dependence of NPV on the Equity Capital Value and Coefficient B.....	320

17.2	Effects of Taxation on the Optimal Capital Structure of Companies in the Telecommunication Sector.	326
	References.	338
18	The Golden Age of the Company (Three Colors of Company's Time).	339
18.1	Dependence of WACC on the Lifetime (Age) of the Company n at Different Leverage Levels.	343
18.2	Dependence of WACC on the Lifetime (Age) of the Company n at Different Values of Capital Costs (Equity, k_o , and Debt, k_d) and Fixed Leverage Levels.	345
18.3	Dependence of WACC on the Lifetime (Age) of the Company n at Different Values of Debt Capital Cost, k_d , and Fixed Equity Cost, k_o , and Fixed Leverage Levels.	348
18.4	Dependence of WACC on the Lifetime (Age) of the Company n at Different Values of Equity Cost, k_o , and Fixed Debt Capital Cost, k_d , and Fixed Leverage Levels.	352
18.5	Dependence of WACC on the Lifetime (Age) of the Company n at High Values of Capital Cost (Equity, k_o , and Debt, k_d) and High Lifetime of the Company.	355
18.6	Further Investigation of Effect.	361
	References.	364
19	Conclusion.	367
	References.	368